VZCZCXRO1675
PP RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHLO #2217/01 2421225
ZNR UUUUU ZZH
P 291225Z AUG 08
FM AMEMBASSY LONDON
TO RUEHC/SECSTATE WASHDC PRIORITY 9613
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY
RUEHOT/AMEMBASSY OTTAWA PRIORITY 1165
RUEHKO/AMEMBASSY TOKYO PRIORITY 1166
RUEHBL/AMCONSUL BELFAST PRIORITY 1098
RUEHED/AMCONSUL EDINBURGH PRIORITY 0966
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY

UNCLAS SECTION 01 OF 04 LONDON 002217

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD EINV UK
SUBJECT: UK SLIDING TOWARDS RECESSION

LONDON 00002217 001.2 OF 004

¶1. (SBU) Summary: The economic news is not good for Great Britain or its Prime Minister. GDP growth was 0.0 per cent in the second quarter of 2008, the worst quarter in 16 years. Inflation hit 4.4% in July, and the Bank of England predicts it will rise to 5% by the end of the year. Employment numbers remain relatively stable, but unemployment is beginning to tick upwards. The Bank of England is faced with the tough choice of combating inflation or attempting to spur economic growth. The public increasingly blames PM Brown for the country,s economic woes, and he has hinted he will propose an economic stimulus package in September. However, HMG,s self-imposed fiscal rule that public debt cannot exceed 40 percent of GDP makes any large recovery package unlikely. End summary.

Recession Expected as Growth Stalls

¶2. (SBU) The UK economy stalled in the second quarter of 2008 with zero percent GDP growth. The Office of National Statistics revised downward its initial estimate that the economy grew by 0.2 percent in the three months leading to June 2008. A U.S. investment bank representative told us that zero percent growth was not totally unexpected and that there is currently no light at the end of the tunnel. Chris Kelly, Senior Economic Advisor at HM Treasury told us there has been very little good news for the UK economy the last few months. The financial markets are still in turmoil, both the U.S. and UK housing markets are weak, and the Euro zone is an especially large drag on the British economy. Kelly said the one bright spot has been recent lower oil prices. The IMF recently downgraded its 2008 growth forecast for the UK to 1.4 percent from the 1.7 percent it predicted in the spring and below the Chancellor,s projection for growth of 1.75 percent. It predicts that growth next year will only reach 1.1 percent, compared with the Chancellor,s current forecast of 2.25 percent. The IMF noted the outlook for the labor market and consumer demand is steadily declining, adding pressure to housing and financial markets. The IMF warned that soaring UK inflation rates leave the Bank of England &little scope8 to cut interest rates to encourage growth.

¶3. (U) The British Chambers of Commerce (BCC) has predicted a technical recession (when GDP declines over two successive quarters), expecting two or three quarters of slightly negative or zero growth followed by a shallow recovery. BCC predicts a prolonged period of weak, below-trend growth lasting through 2009 into early 2010. This forecast was largely echoed by Mervyn King, Governor of the Bank of England. In a press conference for the release of the Bank,s August Inflation Report, King said the Bank,s

central GDP projection is for output to be broadly flat over the next year, so four quarter growth will slow sharply in the near term. He added there was &bound to be a quarter or two8 of economic contraction.

Figures show real quarterly growth and are seasonally adjusted

	Q207	Q307	Q407	Q108	Q208
GDP	0.9	0.6	0.6	0.3	0.0

Inflation Increases

¶4. (U) To add to the misery of low growth, the UK is suffering from increasing inflation. The Consumer Price Index (CPI), HMG,s target measure of inflation, increased to 4.4 percent in July, up from 3.8 percent in June and 2.4 percent above the Bank of England,s target rate. It is important to note, however, that while unemployment has increased and vacancies are falling, wage growth remains contained. The Retail Price Index rose to 5 percent in July, up from 4.6 percent in June. High inflation may also negate any positive effects that a weakening Pound may have on British exports according to HM Treasury,s Chris Kelly. Higher imported input component costs will cancel out exchange rate cost benefits for foreign consumers.

¶5. (U) The Bank of England,s August Inflation Report suggests that higher energy, food and import prices will push inflation to 5 percent in the coming months. The Bank then expects inflation to fall back sharply to a little below the

2 percent target in the medium term but acknowledges the inflation outlook is unusually uncertain. Kelly said that although evidence suggests inflation will increase in the short term, no evidence yet suggests it will remain high in the medium or long terms. The IMF forecast also shows CPI peaking at 5 percent in the short term, averaging 3.8 percent in 2008, and returning to the Bank,s 2 percent target in ¶2010. Consumers, inflation expectations, however, do not match these forecasts. According to a survey conducted by Barclays Capital, consumers believe inflation will rise to 4.7 percent over the next year, and remain close to that level for two years. When asked about expectations for inflation in five years, time, respondents expected an average rate of 4.8 percent. These results reflect public concern over inflation, which could lead to upward pressure on wages and a further drag on growth from depressed consumer expectations for the economy.

(Annual inflation rates) 12 month percentage change)

	Apr08	May08	Jun08	Jul08
CPI	3.0	3.3	3.8	4.4
RPI	4.0	4.3	4.6	5.0

Unemployment Predicted to Rise

¶6. (U) Decreasing growth and increasing inflation put pressure on companies to reduce labor costs. The unemployment rate was 5.4 percent for the three months to June, up 0.2 percent over the previous quarter (but unchanged over the year). In July, the number of people claiming unemployment benefits increased at the fastest rate for almost 16 years as the job market came under intensifying pressure. The number of people unemployed increased by 60,000 over the quarter and by 15,000 over the year, to reach 1.67 million. Howard

Archer, Chief UK and European economist at Global Insight, said: &It seems inevitable that extended very weak economic activity and deteriorating business confidence will exact an increasing toll on the labor market over the coming months.8 Large numbers of lay-offs have meant morale is particularly low in the City (The London banking district), according to a U.S. investment bank representative. Further lay-offs can be expected as financial firms face a particularly challenging business environment. The BCC predicts UK unemployment will increase by 250,000-300,000 over the next two to three years, pushing the number of people out of work close to 2 million. IMF projections put unemployment at 5.5 percent in 2008 and 5.7 percent in 2009.

Seasonally Adjusted (Percentage)

	Q207	Q307	Q407	Q108	Q208
Employment	74.4	74.4	74.7	74.9	74.8
Unemployment	5.4	5.4	5.2	5.2	5.4

Bank of England Resists Pressure to Cut Interest Rate

¶7. (U) Despite all the negative signs, the Bank of England,s Monetary Policy Committee (MPC) continues to resist calls to cut the Bank Rate. The minutes of the Committee,s meeting in August reflect its dilemma: raising the interest rate would send a strong signal to wage and price setters that the Bank would not allow above-target inflation to persist but could adversely affect business and consumer confidence; cutting the rate would help to ameliorate the worst of the downturn in activity but could cause wage and price setters to conclude that the Committee was more concerned about sustaining output growth than about returning to target inflation. Seven MPC members voted to keep the interest rate at 5 percent, while one member preferred an increase of 25 basis points and another preferred a reduction of 25 basis points.

¶8. (U) Industry groups are divided over what the MPC should do next. The British Chambers of Commerce stresses that a

major recession can be avoided if the MPC resists calls to increase the Bank Rate and considers an early cut. It argues that weak demand combined with a squeeze on disposable incomes will constrain inflation and immediate threats to growth are more alarming than dangers of high inflation. However, the Confederation of British Industry (CBI) believes current inflation levels leave little scope for interest rate cuts in the immediate future. In a press release the CBI,s influential Director-General, Richard Lambert, said the Bank was right to leave rates on hold.

	Apr08	May08	Jun08	Jul08	Aug08
Bank Rate	5.00	5.00	5.00	5.00	5.00

Chancellor has Little Room to Maneuver on Public Finances

¶9. (U) So what can the government do? The IMF expects HMG,s sustainable investment rule (which requires public debt as a percentage of GDP be held at a stable and prudent level of 40 percent) to be exceeded for a protracted period. It believes the fiscal deficit will hover around 3.5 percent of GDP in 2008 and 2009. The IMF stressed that any revision of the fiscal rules (which has been widely speculated) should emphasize accountability over flexibility. It recommends the 40 percent net debt ceiling be retained through adoption of a

clear and short horizon to bring debt back under the ceiling following a breach.

¶10. (U) The Institute for Fiscal Studies (IFS) notes the Chancellor has virtually no room left to maneuver. The forecasts from his 2008 Budget, combined with his May 13 &mini-Budget8 announcement of a GBP 2.7 billion giveaway to basic-rate income tax payers and his September 16, 2007 announcement of a postponement in the increase in fuel duties planned for October 1 have left him short of fiscal levers. The IFS also notes that overall receipts of corporation tax in the first four months of this financial year (which began in April) were only 3.2 percent higher than the same four months in 2007. Meeting the Chancellor,s Budget forecast would require annual growth of 10.6 percent. July receipts from North Sea oil companies more than doubled from July 2007, bringing in an extra GBP 2 billion to the Treasury. But receipts of corporation tax from other companies fell by a quarter, costing the Treasury GBP 2 billion. The IFS is also concerned that spending by central government has been growing more quickly over the last quarter than that forecast in the Budget for the year as a whole.

	Apr08	May08	Jun08	Jul08
Current Budget (Billions) (Deficit in brackets)	0.6	(9.1)	(7.6)	6.6
Public Sector Net Lending (Billions-Borrowing in brackets)	0.5	(11.0)	(9.2)	4.8
Public Sector Net Debt (Percentage of GDP)	36.5	37.2	38.3	37.3

Public Blames Brown

¶11. (U) All of this adds up to political problems for an already beleaguered PM Brown. More than three-quarters of respondents to an FT/Harris poll on August 26 said the government bore at least some of the blame for the economic downturn and its consequences, with 56% believing Ministers had most or complete responsibility. Only 3% of respondents rated the handling of the downturn and its consequences as good, while 63% said that it had been bad or terrible. The results suggest Gordon Brown,s continued emphasis on the global nature of the slowdown has failed to convince the public.

¶12. (SBU) PM Brown has hinted publicly that next month he will outline measures designed to ease pressures on living costs and the housing market. Although 10 Downing Street has not yet released any official details, there has been much speculation about his plans. One theory is that he may

suspend the stamp duty, the tax paid when buying a home, in an attempt to spur the sagging housing market. However, these rumors have so far had the opposite effect. Many would-be home buyers are postponing their purchase in anticipation of the suspension of this tax. Another theory is that PM Brown may distribute a one-time handout of 150 GBP ($285 USD) to parents. The nominal purpose of the handout would be to help families cope with energy price inflation, but the impact of such a relatively small sum on economic growth is debatable.

HMG,s Hands are Tied, Expect Inaction

¶13. (SBU) Comment: Few options for jump-starting the economy remain open to HMG, because of its self-imposed limitations and rules. The independent Bank of England is unlikely to lower interest rates in the next few months, despite likely pressure from Chancellor Darling. The Bank,s remit is to

keep inflation under a specific target of two per cent. With inflation more than double that amount, the Bank will likely take a &wait and see8 attitude. Bank of England Governor Mervyn King has publicly resisted calls to lower interest rates. In meetings earlier this summer, Bank of England Deputy Governor John Gieve and MPC member Paul Tucker both told us that inflation is their primary concern. It will most likely take an actual recession to prompt the Bank of England to lower interest rates. During his years as Chancellor of the Exchequer, PM Brown imposed strict limitations on borrowing in order to limit public debt. The opposition Conservatives would showcase any reversal of his rules as more evidence he is unfit to steer the country away from a recession. These limitations effectively prevent the current Chancellor from making any large increases in public spending or significantly lowering taxes. The Pre-Budget Report this fall will likely contain a few largely superficial proposals for re-starting the economy, but nothing drastic. Only a change in Labour party leadership or an election may prompt radical economic action. A new Labour Party leader or a Conservative government would not be constrained by Brown,s fiscal rule limiting public debt and would have more flexibility to respond to a weakening economy. End Comment

Visit London's Classified Website:
http://www.intelink.sgov.gov/wiki/Portal:Unit ed_Kingdom

LEBARON